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Economic Conditions
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General Business Conditions

THE sense that major events are impending in Europe, and that "anything can happen" at this stage of the war, has been heightened by the great Russian victories during the past month, and by reports of growing strain inside Germany. With their armies being forced back, their submarines ineffective, their war plants and cities bombed, and their power to take the offensive destroyed, the German people can hardly be buoyed much longer by hope; and if they are losing hope it can rightly be said that the war is approaching its last stages.

Conversely, the United Nations are beginning to look for a shortening of the war. It should be unnecessary to add that their own hopes should not run too high, nor should their domestic policies be swayed by them, where the effect would be to weaken support of the military effort. Except for the bombing, the battlefronts are still far from German territory. German resources are great enough to carry on a prolonged war, even if the hope is only to ease defeat rather than escape it. Until signs of German economic or military collapse are far more conclusive than they are today, war must continue to be the full time business of this country.

The Domestic Situation

The outstanding fact in the domestic situation is that industrial production in the aggregate is making but small increases because of the limitations of manpower. At the same time the proportion of the output devoted to war has reached a level which will be hard to raise. According to a calculation by the Board of Governors of the Federal Reserve System, 70 per cent of industrial production is now for war uses. This tremendous figure is a measure of the grip of the war on the industries; it also suggests by its magnitude that the adjustment of the industrial organization to the war effort has proceeded, in the broad sense, nearly as far as it will go. Cutbacks of procurement programs in some directions, made possible by the building up of stockpiles and by changes in requirements, are now offsetting to some extent the expansion needed in other weapons.

Mr. Wilson, vice-chairman of the War Production Board, is quoted as saying of war requirements that "over-all gains are not so important as are gains in specific items," which implies a satisfactory situation in many lines. A notable change in the navy program was announced by Secretary Knox October 29, when he said that 427 anti-submarine vessels contracted for but not yet started will not be built. This move—a striking demonstration of the success of the anti-submarine campaign—will release labor and materials for other purposes, including a stepup in production of landing craft and amphibious vessels. In the Army the concentration is on the effort to increase airplane production, which in October made excellent progress.

From every standpoint it is desirable that the procurement program should be under close and constant scrutiny, and responsive to changing military developments. Elimination of waste, avoidance of excessive stockpiling, and economy in the war effort have the same effect as individual saving. They cut down the magnitude of the fiscal problem and reduce the inflationary danger. They make possible, by the release of manpower and materials, a speedier and more effective job in turning out the airplanes and other offensive weapons for which the need is acute. At the same time they permit more consideration for the provision of goods and services which, although classified as civilian needs, are necessary to maintain productive efficiency; examples are farm and transportation equipment and local housing and utility services.

The manpower shortage is acute, and most civilian industries feel its pressure, which cuts their output. Probably some will have to give up more workers to the war plants, to obtain the big increase in airplane production that is scheduled. Paper and leather are tighter. However, with many materials in better supply, and some War Production Board restrictions

eased moderately, production of civilian goods is expanding in some directions about as much as it contracts in others, and in the aggregate is showing little change.

The volume of merchandise production is not up to the wants of the buyers who are flocking into the wholesale markets, and inventories are declining, which implies more scarcities in the future; but production plus inventories supports an amount of civilian business which confounds the prophets of a year ago, and which is all the more remarkable in that—so far as manufactured goods are concerned—it is produced by only 30 per cent of the country's industrial organization.

Further striking testimony as to the industrial achievement during the war is provided by a revision of the Federal Reserve Board's industrial production index, giving effect to new data on man-hours of employment and to productivity per man-hour. This revision raised the July index from 203 to 239 (1935-39 =100) and established August and September at 242 and 243, respectively. In other words, the Board has concluded that instead of being double the pre-war level, production is nearly two and one-half times that level. Dividing industrial output, as measured by this figure, between civilian and war production, the calculation shows that civilian production is 25 to 30 per cent below the 1935-39 average, while for war alone the industries are turning out 70 per cent more than their entire production for all uses in those pre-war years. The showing is one of efficiency and resourcefulness without parallel in industrial history.

Third Quarter Earnings

Reports for the third quarter and the first nine months issued by leading industrial companies show, in a majority of cases, an increase in net income after taxes as compared with the corresponding periods of 1942, when many industries were in the process of converting from peace to war work, but a decrease as compared with the levels of the prewar year 1941. Continued expansion in output of war goods is carrying the volume of sales by the manufacturing industry, taken as a group, to a new high peak this year. Industrial earnings, however, have tended to become stabilized to considerable extent by the high income taxes, which for companies reporting tax details absorbed about 68 per cent of net income before taxes in the first nine months. Such taxes now serve to offset the major portion of any change — either upward or downward — in corporate earnings before taxes.

Our tabulation of the reports of 275 leading industrial companies issued to date shows, for the first nine months, a combined net income after taxes of approximately $799 millions, which represents an increase of 13 per cent from the $709 millions reported by the same companies in the corresponding period of 1942, but a decrease of 21 per cent from the $1,009 millions in 1941. Earnings as given on interim statements are shown after allowance for contingency and general reserves, if any, but are subject to renegotiation of government contracts, to possible changes in tax rates made retroactive, and to the usual year-end adjustments and reserves. This group, representative of the larger manufacturing organizations, employed a capital and surplus aggregating $12,084 millions at the beginning of this year, upon which the annual rate of return was 8.8 per cent, compared with 8.1 per cent last year and 12.3 per cent in 1941.

The summary on the next page presents, by major industrial groups, the comparative figures for the past two years of net income after taxes, net worth, and annual rate of return.

Sales figures reported by 73 manufacturing companies totaled $10,427 millions in the first nine months compared with $7,781 millions last year, an increase of 34 per cent. Sales increased considerably faster than did net income after taxes, indicating lower margins of net profit per dollar of sales.

Taxes and Net Income

The quarterly trend of net income after taxes during 1941-43 has been as follows for the companies tabulated:

Net Income After Taxes of 275 Leading Industrial Corporations
(In Millions of Dollars)

	1941	1942	1943
First quarter	$334	$234	$258
Second quarter	336	216	263
Third quarter	339	259	278
Nine months	1,009	709	799
Fourth quarter	334	357	......
Year	$1,343	$1,066	......

The quarterly earnings figures illustrate the 1941-42 decline resulting from conversion, followed by the 1942-43 recovery as the changeover was completed and war production expanded, and also show the "floor" and "ceiling" effects upon net income of the prevailing high war taxes. Analysis of the tax details given by 175 companies in the group, whose net income accounted for over three-fourths of the total, indicates that net income before taxes, and estimated reserves for income and excess profits taxes were as follows:

Net Income and Estimated Income Tax Reserves of 275 Leading Industrial Corporations
(In Millions of Dollars)

	First Nine Months 1942	1943	Per Cent Change
Net income before taxes	$2,209	$2,524	+14
Federal income and excess profits taxes	1,500	1,725	+15
Net income after taxes	$ 709	$ 799	+13

As already stated, taxes absorbed about 68 per cent of net income in the first nine months of this year, or about the same as in 1942, while in 1941 they absorbed 54 per cent.

Tax reserves are shown after deduction of the 10 per cent credit for post-war refund on excess profits taxes. In some instances, the reserves cover, in addition to federal income and excess profits taxes, an unknown but probably small amount, relatively, of capital stock taxes, state income taxes and foreign income taxes.

Such reserves do not include, however, the numerous other federal, state and local taxes paid by the corporations and charged as operating costs, such as franchise taxes, real property taxes, gross income taxes, sales taxes, excise and manufacturers' taxes, old-age insurance taxes, unemployment taxes, etc.

Utility Earnings Improve

This year there has been a moderate improvement in the net earnings of representative electric power companies, thereby reversing the downward trend that prevailed in 1941 and 1942 as a result of rapidly rising operating costs and taxes. Gross revenues of a group of 25 leading systems for the first nine months were about 7 per cent above the corresponding period of last year, the increase coming chiefly from the war industries. Operating expenses and taxes also advanced, but fixed charges were lower, so that net income increased by 12 per cent. In the next column is a condensed summary by quarters.

Gross and Net Earnings of 25 Leading Public Utility Systems for the First Nine Months
(In Thousands of Dollars)

Operating revenues	1942	1943	% Change
First quarter	$281,135	$294,161	+ 5
Second quarter	256,135	277,325	+ 8
Third quarter	258,635	276,818	+ 7
Nine months	$795,905	$848,304	+ 7
Net income after taxes			
First quarter	$ 38,254	$ 38,660	+ 1
Second quarter	25,787	30,958	+20
Third quarter	23,178	28,242	+22
Nine months	$ 87,219	$ 97,860	+12

The electric public utility industry is continuing to meet successfully the unprecedented demands for electric power and light by the converted, expanded and new war industries, plus vast military camps throughout the country and sustained heavy consumption by residential and commercial users despite the dim-outs. The flexibility shown by the utility systems in meeting the rapidly changing requirements has made possible one of the great records established by American industry during this war. The record is the more remarkable because it was achieved in the face of serious difficulties and delays in obtaining new equipment, copper, and other supplies, and with an acute man-power problem caused by the loss of many thousands of technicians to the armed services.

Earnings of All Corporations

Recently the Treasury Department made public additional preliminary figures on the Statistics of Income for 1941 compiled from tax returns of all corporations in the United

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST NINE MONTHS

Net Income is Shown After Depreciation, Interest, Taxes, and Other Charges and Reserves, but Before Dividends. — Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

No. of Cos.	Industrial Groups	Net Income Nine Months 1942	Net Income Nine Months 1943	Per Cent Change	Net Worth January 1 1942	Net Worth January 1 1943	Annual Rate of Return % 1942	Annual Rate of Return % 1943
7	Baking	$ 12,750	$15,151	+ 18.8	$210,604	$212,821	8.1	9.5
16	Food products—other	39,541	44,071	+ 11.4	452,637	466,894	11.6	12.6
10	Textiles and apparel	7,477	7,754	+ 3.7	107,569	111,445	9.3	9.3
12	Paper products	8,413	8,834	+ 5.0	174,489	180,610	6.4	6.5
25	Chemicals, drugs, etc.	112,447	122,001	+ 8.5	1,433,188	1,488,888	10.5	10.9
15	Petroleum products	94,236	114,329	+ 21.3	1,821,961	1,864,010	6.9	8.2
11	Stone, clay and glass	14,674	16,857	+ 14.9	315,008	324,105	6.2	6.9
23	Iron and steel	130,498	131,351	+ 0.7	3,172,618	3,237,209	5.5	5.4
8	Electrical equipment	37,841	45,017	+ 19.0	426,488	441,810	11.8	13.6
18	Machinery	21,366	24,552	+ 14.9	218,330	231,353	13.0	14.1
15	Autos and equipment	97,310	125,060	+ 28.5	1,229,496	1,322,318	10.6	12.6
8	Railway equipment	10,891	11,774	+ 8.1	185,279	190,137	7.8	8.3
36	Metal products—other	54,409	53,063	— 2.5	784,170	800,572	9.2	8.8
20	Misc. manufacturing	15,372	20,196	+ 31.4	258,600	263,584	7.9	10.2
224	Total manufacturing	657,225	740,010	+ 12.6	10,790,437	11,135,756	8.1	8.9
31	Mining and quarrying	34,621	34,612	—	576,109	583,704	8.0	7.9
12	Trade (whol. and retail)	12,630	18,886	+ 49.5	234,907	244,486	7.2	10.3
8	Service and construction	4,850	5,661	+ 16.7	115,915	120,048	5.6	6.3
275	Total	$709,326	$799,169	+ 12.7	$11,717,368	$12,083,994	8.1	8.8

* Before certain charges.

States, and also certain estimates for the years 1942 and 1943. These, with figures for two other periods of peak business activity, 1917-19 and 1927-29, are summarized in the accompanying table, while the relative income tax and dividend payments are shown separately in a graph. The net income figures are based upon the statutory definition for tax purposes and show earnings before charges for the various general, contingency and post-war reserves, which are not allowable deductions for tax purposes; had these reserves been allowed for, the net income shown, particularly in 1942-43, would have been correspondingly lower.

Earnings, Taxes and Dividends of All Corporations in the U. S. During Three Periods of Peak Business Activity
(In Millions of Dollars)

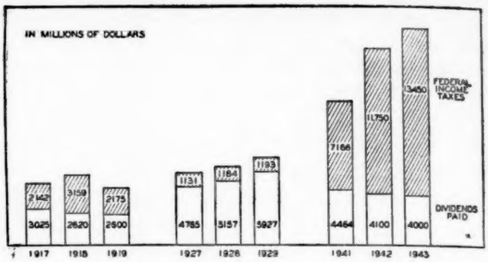
Year	Gross Corporate Receipts-a	Net Income before Taxes	Federal Income Taxes-b	Taxes to Net Income %	Net Income after Taxes-a	Net to Gross Income %	Net Dividends Paid-a	Retained Net Income
1917	$84,693	$9,484	$2,142	22.6	$7,842	8.7	$3,025	$4,317
1918	86,611	7,818	3,159	40.4	4,659	5.4	2,620	2,039
1919	100,098	8,594	2,175	25.3	6,419	6.4	2,600	3,819
1927	143,241	7,011	1,131	16.1	5,880	4.1	4,765	1,115
1928	151,388	8,750	1,184	13.5	7,566	5.0	5,157	2,409
1929	158,565	9,277	1,193	12.9	8,084	5.1	5,927	2,157
1941-p	188,474	14,107	7,166	50.8	6,941	3.7	4,464	2,478
1942-e	225,000	19,850	11,750	59.2	8,100	3.6	4,100	4,000
1943-e	250,000	22,000	13,450	61.1	8,550	3.4	4,000	4,550

(a) Excluding intercorporate dividends. (b) Includes excess profits taxes and war taxes. (e) Estimated. (p) Preliminary.

In the years 1917-19, federal income taxes (including war and excess profits taxes) absorbed from 23 to 40 per cent of corporate net income, while in 1941-43 the estimated taxes will absorb 51 to 61 per cent. Net income after taxes is now running, on the basis of the estimates used, considerably higher than in 1917-19, but the total capital investment of American business today is also far greater than during the last war. At the end of 1940, the total capital and surplus of all corporations aggregated $138,387 millions, but corresponding capitalization figures were not compiled at the time of the last war.

A significant measure that can be made on a fairly comparable basis, however, is the percentage of corporate net income after taxes to gross receipts or volume of business. In the period 1917-19 this averaged about 6.8 per cent, and in 1927-29 about 4.7 per cent. In 1941-43, the ratio of actual or estimated net income to gross corporate receipts (roughly estimated for 1942-43 on the basis of national income) is but 3.6 per cent. The portion of gross receipts actually paid out in dividends during these three periods averaged, respectively, 3.1 per cent, 3.5 per cent and 1.9 per cent.

Taking the actual distribution of corporate net income as between federal income taxes and dividends paid to shareholders, as shown on the graph, and disregarding retained net



Federal Income Taxes and Dividends Paid by All Corporations in the U. S. During Three Periods of Peak Business Activity.
(1942 and 1943 estimated)

income (which may, or may not be passed on to shareholders at some time in the future), the division was as follows:

	1917-19	1927-29	1941-43
Federal income taxes	47.5%	18.1%	72.0%
Dividends paid	52.5%	81.9%	28.0%

These figures show how much less the corporate shareholders, taken as a group and now numbered in the millions, are receiving as compared with the last war, or compared with the active business years in the late 1920s. The shareholders' net yield has been cut even more sharply, since any corporate net income, after taxes, that is distributed as dividends is again subject to tax at the high federal individual income and surtax rates, and to state income taxes as well in 34 states and the District of Columbia.

The Problem of New Taxes

The reception by Congress of the Treasury's tax proposals has revealed a wide cleavage of opinion regarding additional taxes. Not only are there the usual differences as to what kinds of taxes are needed, but there is also important disagreement as to total amounts. For the first time in the World War II financing Congress has refused to go along on substantially the quantity of new taxes asked for by the Treasury, and the summary manner in which the Ways and Means Committee rejected the Treasury's recommendations has emphasized this refusal. Opinion voiced in Committee hearings ranged all the way from $13.8 billions asked for by Chairman Eccles of the Federal Reserve Board and the $10½ billions requested by the Treasury, to no tax increases at all.

The widely differing views upon so vital a matter as tax policy seem to call for some re-definition of objectives and review of progress in reaching them. What are we trying to do, and how are we getting on with the job?

We are trying of course to do two things: first, to check the growth of debt, so as to lessen the dangers from that source in the post-war period; second, to offset as much as possible the stream of Treasury spending

which is threatening to burst the barriers of price controls, with serious consequences both to the war effort and to post-war reconstruction.

As for the objective of holding down the debt, little need be said here. Most everyone recognizes the importance of doing this, and the extent to which it is done is just a question of how much we can cut out unnecessary spending and increase total tax collections. The question, however, of countering the effects of inflationary Treasury spending is more complicated. The elements of this problem were outlined by Secretary Morgenthau in his statement before the Ways and Means Committee on October 4.

Citing estimates of income payments to individuals for the fiscal year 1944 at $152 billions, Mr. Morgenthau estimated that goods and services available would amount to only $89 billions, leaving a surplus of income payments of $63 billions. Of this $63 billions "excess," Mr. Morgenthau figured that personal taxes at present rates would take $21 billions, while sales of war bonds to individuals, projected at the rate of the past year, would absorb another $17 billions, thus reducing the total of "excess" purchasing power from $63 billions to $25 billions. Even allowing for other regular forms of savings, such as life insurance, there would still remain, the Secretary pointed out, disposable purchasing power far in excess of the limited quantity of goods available.

It is this "gap" between the total of spendable income and the total of goods and services to spend it on that constitutes the heart of the inflation problem. How much further ought taxes be raised in the effort to close this gap?

Taxes and the "Inflationary Gap"

In attempting to answer this question it ought to be realized, in the first place, that it is neither practicable nor desirable to try to raise taxes enough to close this gap entirely. Secretary Morgenthau recognized this when he said in his statement "we cannot (by tax legislation) possibly absorb enough of our dangerous dollars"; and even the huge sum of $10½ billions of new taxes asked for by the Treasury would fall short by many billions of dollars of equalling the so-called "excess spending money" being put into circulation.

The fact is that this much-discussed "inflationary gap" is very largely a statistical abstraction and a quite imperfect measure of the inflationary forces present in a situation. What it fails to do is recognize that the psychological attitude of the public is probably fully as important as any particular mathematical relationship between total spendable incomes and total available goods over a given period. For if people are not in a spending mood, either because they cannot get the goods they want, or for patriotic reasons, or because increasing taxes are inducing an attitude of caution, inflationary pressures will be held back just as effectively as though taxes were higher. This, indeed, has been the situation here to date. The disinclination of people to spend all they get, but to hold some of their money idle and to pay their debts, has been a powerful reinforcement to other measures to curb inflation.

On the other hand, if for any reason—say, lack of confidence in the ability to control inflation—the psychological attitude towards spending changes, not even the "inflationary gap" would be a full measure of the danger. For then, besides spending their current incomes, people might try to convert past savings into goods.

All of which serves to prove two things—(1) that there is no precise measuring rod for determining how much taxes are needed to prevent inflation, and (2) that wartime taxation serves a dual purpose. As one writer has put it, "wartime tax policy can achieve two purposes at the same time; it can contribute to make the inflationary gap manageable and can contribute to the formation of attitudes which take care of the unmanaged remainder of the gap."*

What Scope for New Taxes?

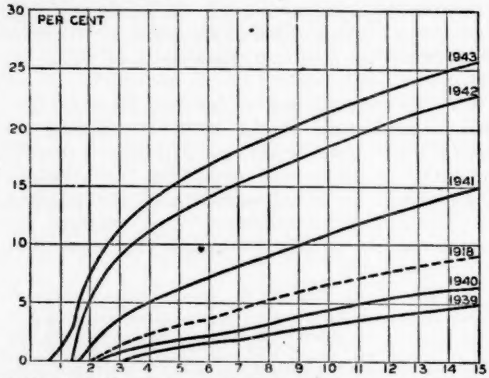
These principles need keeping in mind in connection with our present tax problem. We cannot tax enough to eliminate inflationary dangers entirely. At the same time we want to tax as much as possible, both to draw off inflationary purchasing power and keep the right atmosphere of saving and not spending on the part of the public.

In determining how much to tax, we must, however, take account of the tax burdens that people are already carrying. Since 1939 the total gross federal taxes paid by the American people have increased from around $5.7 billions to an estimated $40.3 billions for the current fiscal year, or more than seven times, and such taxes are nearly six times greater than at the peak of World War I. Direct taxes (other than social security) on individuals have increased since 1939 from around $1 billion, to an estimated $18.8 billions this fiscal year, while direct taxes on corporations have risen from $1.2 billion to $14 billions. And to the estimated total of $40 billions of federal taxes payable this year must be added some $10 billions of local government taxes, lifting total taxes to around $50 billions.

Part of the huge increase in federal taxes has been due, of course, to the expansion in the volume of business and national income subject to tax, but most of it reflects the sharp

* "War Without Inflation" by George Katona, Columbia University Press, 1942.

increase in tax rates, as well as broadening of the tax base to bring in new taxpayers. The accompanying diagram indicates the drastic nature of the tax increases that have been levied upon personal incomes. Figures are given for 1918 to show comparison of tax rates in the two wars.



Estimated Percentage of Gross Income, by Income Classes up to $15,000, Taken by Federal Income Taxes in Different Years.

The raising of rates during recent years has of course been sharper, relatively, in the low and medium brackets than in the high brackets for the reason that the latter already paid extremely high rates even in 1939. Taxes on 1943 incomes do not include the 25 per cent of the 1942 or 1943 tax not abated, and payable half in March 1944 and half in March 1945, and do not include state income taxes.

Certainly, the present tax rates make a strong case for caution and moderation in imposing additional burdens upon the people. It is of course perfectly true that many persons, particularly workers in war industries, have experienced income increases that would make it possible for them to pay higher taxes without hardship. But barring some form of tax on income increments — which so far has been deemed impracticable—this cannot be taken as a criterion for tax policy. For, as we all know, not only are income increases distributed unequally, but likewise the purchasing value of incomes varies widely in different parts of the country. The $3,000 or $4,000 white collar worker in a big city, for example, may be worse off than a farmer with cash income of only $1,000. As tax rates rise higher and higher there comes a point somewhere at which additional increases will become unduly oppressive, with consequent impairment of morale and working efficiency. The question is, whether we are not already reaching that point.

1944 Budget Trend Better Than Estimated

An additional factor to be considered in connection with new taxes is the favorable trend of government receipts and expenditures compared with budget estimates. Based on figures for the first quarter of the fiscal year, receipts are running at an annual rate some $3 billions above budget estimates and expenditures some $15 billions below. We are, in other words, collecting substantially more taxes than we expected, and spending a great deal less.

As a result, the indicated deficit for the year is reduced from the budget figure of $66 billions to $48 billions, of which the portion requiring financing during the eight months November through June is $31 billions.

As against this $31 billions, the Treasury had on October 28 cash balances of $19 billions. By drawing these down to, say, $9 billions, there would be provided $10 billions of the $31 billions required, leaving $21 billions still to be taken care of.

Allowing for regular sales of war savings bonds at the rate of over $800 millions a month net after redemptions, or $7 billions for eight months, this $21 billions would be cut to $14 billions, while social security taxes and other government trust fund investments should account for another $2 billions, thus bringing the remainder requiring financing down to around $12 billions, or a considerably smaller sum than was raised in the Third War Loan drive.

These figures are significant for several reasons. They mean that if present trends continue, a Fourth War Loan some time early next year should be able to take care of Treasury requirements for the balance of this fiscal year without further dependence upon commercial bank borrowing with its inflationary creation of new deposits. Even if the volume of funds required from the open market should prove as high as $15 billions, this would still be well within the sum raised from non-commercial banking investors in the Third War Loan.

It may even be true that the Treasury's cash requirements beyond this fiscal year can be financed out of taxes and savings with no real need of additional offerings of government securities to the banks. It seems probable that the revenue gains for the first quarter underestimate rather than overestimate the productiveness of present taxes. The national income on which taxes apply is still rising. Tax yields in the July-September quarter do not reflect the 12½ per cent personal income tax carryover payable in March of 1944, which should more than offset any refunds due; likewise, the first quarter receipts may not fully reflect the annual yield from the new withholding taxes, on which the first monthly collections were made in August. Moreover, no allowance has been made for the cash receipts resulting from the continuing excess of tax note sales over redemptions.

On the expenditure side, with the vast construction phase of the war program now virtually completed, and with the tremendous outpouring of munitions and equipment of all kinds that has taken place, there are indications that the rate of expenditures may have reached its peak. For the past eight months, the war expenditures have flattened out around the $7 billions level, and recently Mr. Charles E. Wilson of the W.P.B. was quoted as saying that production is approaching the ceiling. In many sections of the program, cancellations of orders and cut-backs in production are taking place. In view of the growing awareness and agitation for the need of reducing unnecessary government costs, it may well be that savings in the sum-total of expenditures can be effected. The chairman of the Senate Finance Committee, Senator George, was quoted in the press as estimating that at least $5 billions could be saved by economies.

The possibility that we may be at or near the point of being able—with vigilance against wasteful spending and with intensified drives to sell war bonds to genuine investors—to cover our financial requirements by taxes and non-inflationary borrowing outside the banking system, ought not to be overlooked in weighing the problem of new taxes.

Taxes to Cut Spending

The foregoing does not mean of course that there is no need for additional taxes at this time. The budget deficit is still so large, and the uncertainties of projecting receipts and expenditures so great, that we ought to be getting in as much tax money of the right sort as we can. Moreover, although the bond drives are becoming increasingly successful in their sales to individuals, they still depend too much upon corporate and institutional investors. Finally, additional taxes would help to keep down the debt that will have to be serviced after the war.

Last month Secretary Morgenthau stated before the Ways and Means Committee:

> Today four-fifths of all the income of the nation is going to people earning less than $5,000 a year. And, except for the people earning no more than a bare subsistence wage this group presents the greatest potential danger from the inflationary standpoint. The weight of the inflationary money in the hands of this group can cause undue price rises, and can completely upset our entire economic system, unless absorbed in sufficient quantity.

If this be true, then there is no doubt where the bulk of the increased taxes should fall. There is no use trying to get the money out of the upper "fifth", since the income of this group—especially after paying existing taxes—is comparatively small; also that is not where the inflationary danger lies. Nor is there any use trying to get it out of the corporations, for such taxes likewise would not get anti inflationary money, but would endanger initiative and incentive and impede accumulation of necessary reserves. We must go where the money is, namely, the "four-fifths" of the national income stated by the Secretary to be flowing to persons receiving less than $5,000.

Thus the question comes down to, what are the best types of taxes to do this? Direct taxes on income already have been drastically raised, and are particularly hard to bear by persons whose incomes have not increased or who live in localities where living costs are relatively high. Moreover, it must be borne in mind that direct taxes upon incomes will be increased next year by existing law—one increase being the 12½ per cent carryover on personal taxes payable in March, and another being the doubling of the social security taxes payable by both employes and employers, effective next January 1.

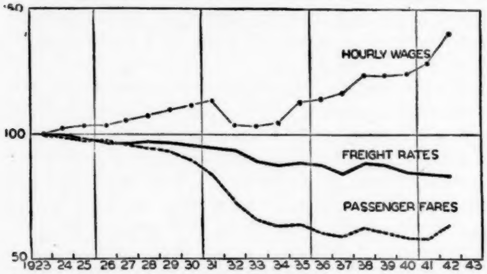
Taxes on consumption, on the other hand, can and should be increased. Whether in the form of excise taxes, or general sales taxes, they afford opportunity for reaching large masses of people, while at the same time—through suitable exemptions and graduations—providing some adjustment of tax for necessities and luxuries. Moreover, people can within limits elect to pay or not to pay, simply by spending or not spending. Such taxes, in other words, operate directly to encourage saving and to penalize spending, and that is precisely what we want to do.

The Railroads' War Achievement (Second Article)

Last month we discussed the wartime performance of the American railroads, which in the second year of World War II, under private ownership, are successfully handling a volume of freight traffic 80 per cent greater than they moved in the second year of World War I, under government operation, and a passenger business almost double the 1918 figure. This extraordinary achievement has been made possible, we showed, largely as a result of a program of rehabilitation and modernization initiated by the carriers as far back as 1923.

Having surveyed this twenty-year program in terms of operating results, it is appropriate to consider next its effects on the revenues of the railways and their financial position. In the two decades the roads have had to contend with a major growth of competition from other forms of transportation, with the most costly and prolonged business depression in the country's history, with rising wage rates, and since the middle '30s with rising taxes. But from the standpoint of giving the American people a steadily improving transportation service at steadily declining costs, the railroads have met these adverse circumstances triumphantly.

The benefits of the reductions in costs, derived from the modernization, improvement and increases in efficiency described in our previous article, were passed on both to labor and the public. Although average hourly wage rates advanced 39 per cent between 1923 and 1942, freight rates and passenger fares were regularly lowered through the twenty years, as the accompanying chart (which compares them with



Indexes of Average Freight Revenue per Ton-mile, Passenger Revenue per Mile, and Hourly Earnings of Employes of All Class I Railways. 1923 = 100.

wage rates, all on a base 1923 = 100) shows. Credit is due to the railroads for this achievement, which has now been crowned by their service in the war.

On the other hand, the roads had from 1931 through 1940 ten years of fantastically low earnings, including four years of deficit, in the aggregate, after fixed charges. The table at the bottom of this page gives operating income figures of the Class I roads since 1916. The record prior to 1941 shows that the lower-cost service to the public was achieved not only by increased efficiency, but in considerable part through the sacrifice of investors. The decline in dividend payments speaks for itself, and over and above that is the story of insolvencies. As of July 31 this year approximately 67,000 miles of road or 28 per cent of the nation's total were undergoing financial reorganization.

Wartime Earnings

With a twenty-year record of increases in efficiency and technological advance, it is not surprising to find that the wartime jump in traffic has lifted earnings abruptly from their long depression. The income table gives the story. In 1942 all previous earning records went by the board. Total operating revenues, as will be seen, reached $7,466 millions, against $6,280 millions in 1929; net operating income (in spite of a rise in taxes from $397 millions to $1,199 millions) amounted to $1,485 millions, compared with $1,252 millions, and net income after fixed charges, $902 millions, exceeded that of 1929 by $5 millions.

For the first eight months of this year net operating income totalled $948 millions, against $821 millions in the corresponding period of 1942, but this favorable comparison was built up during the first five months. Since May net operating income has been running behind that of 1942. One reason for this is a moderate flattening out of the traffic curve. A second is the suspension as of May 15 of an emergency freight rate increase which was yielding some $25 millions a month. A third is

Operating Income Account All Class I Railroads, 1916-1943
(In millions, except where otherwise indicated)

	Investment in Road and Equipment	Freight Revenues	Passenger Revenues	Total Operating Revenues-b	Total Operating Expenses	Transportation-Ratio-c	Tax Accruals	Net Ry. Operating Income	% Return on Investment	Other Income	Income Available for Fixed Charges	Fixed Charges Accrued	Net Income-d	Dividend Paid-e
1916	$16,884	$2,575	$ 708	$3,597	$2,357	32.6	$ 157	$1,040	5.90	$ 210	$1,250	$ 603	$ 647	$ 306
1917-a	17,762	2,833	827	4,014	2,829	37.9	214	934	5.02	233	1,167	574	593	320
1918-a	18,214	3,454	1,033	4,881	3,982	41.4	223	639	3.33	416	1,054	668	387	275
1919-a	18,530	3,556	1,180	5,145	4,400	42.1	233	455	2.33	622	1,077	631	447	279
1920-a	19,061	4,328	1,289	6,178	5,828	47.0	272	17	0.09	1,053	1,071	641	431	272
1921	19,579	3,924	1,154	5,517	4,563	41.1	276	601	2.91	375	976	662	314	298
1922	19,871	4,006	1,076	5,559	4,415	38.4	301	760	3.64	265	1,025	656	370	272
1923	20,657	4,622	1,148	6,290	4,895	36.9	332	962	4.42	261	1,223	667	555	297
1924	21,469	4,346	1,076	5,921	4,508	36.5	340	974	4.32	269	1,243	685	558	320
1925	22,535	4,553	1,058	6,123	4,537	35.0	359	1,121	4.75	268	1,389	688	701	342
1926	23,203	4,810	1,043	6,383	4,669	34.1	389	1,213	4.99	298	1,511	702	809	399
1927	23,967	4,644	976	6,136	4,574	34.8	376	1,068	4.27	311	1,359	681	673	412
1928	24,463	4,691	902	6,112	4,428	34.0	375	1,173	4.61	320	1,470	683	787	431
1929	25,054	4,826	874	6,280	4,506	33.1	397	1,252	4.81	360	1,589	680	897	490
1930	25,657	4,083	729	5,281	3,931	35.0	349	869	3.28	359	1,207	671	524	497
1931	25,701	3,254	551	4,188	3,224	36.8	304	526	1.99	306	807	660	135	330
1932	25,699	2,451	377	3,127	2,403	36.9	275	326	1.24	225	527	654	—139	92
1933	25,527	2,493	329	3,095	2,249	34.9	250	474	1.82	211	672	666	— 6	96
1934	25,345	2,633	346	3,272	2,442	35.3	240	463	1.78	203	648	653	— 17	133
1935	25,230	2,791	358	3,452	2,593	36.3	237	500	1.93	188	668	649	8	126
1936	25,153	3,309	412	4,053	2,931	35.0	320	667	2.57	184	831	653	165	170
1937	25,312	3,378	443	4,166	3,119	36.0	326	590	2.27	175	740	629	98	168
1938	25,288	2,858	406	3,565	2,722	37.8	341	373	1.43	155	503	614	—123	83
1939	25,264	3,251	417	3,995	2,918	37.0	356	589	2.25	161	725	608	93	126
1940	25,397	3,537	417	4,297	3,089	34.9	396	682	2.59	169	824	609	189	159
1941	25,406	4,448	515	5,347	3,664	33.2	547	998	3.75	177	1,137	620	500	186
1942	25,579	5,944	1,028	7,466	4,601	30.3	1,199	1,485	5.50	183	1,618	659	902	202

(a) Railroads operated by the Government, Dec. 26, 1917 - Feb. 29, 1920, a period of approximately 26 months. (b) Includes mail, express and other revenues. (c) Ratio of direct operating (transportation) costs to total operating revenues. (d) Available for additions to property, reserves, dividends, etc. (e) Exclusive of stock dividends. (—) Deficit.

the general increase in taxes and operating costs, taxes alone being higher by about $500 millions. Further wage increases are pending, which may be made retroactive; some roads have set aside sums to meet them, but the majority have not.

Reducing Debt and Interest Charges

Wisely the roads are paying out only a modest proportion of the earnings increase in dividends; rather they are accelerating the retirement of debt, reducing their interest charges and increasing cash and working capital to enable them to meet postwar needs. The peak of railroad funded debt, according to I.C.C. reports, was reached in 1930, when the total unmatured funded debt outstanding stood at $11,880 millions. At the end of 1942 the comparable figure was $10,354 millions, a decline of 12.8 per cent. In 1942 alone the reduction in long and short term debt of the Class I roads (other than those undergoing reorganization) approximated $325 millions. The process has been speeded up again in 1943, largely through the use of earnings to buy in outstanding bonds. The reduction in interest charges on funded debt of these roads in 1942 was nearly $18 millions.

The magnitude of reduction in the debt of roads in receivership or trusteeship—which is a contribution of the owners of the bonds to the restoration of the roads' credit—is illustrated by the fact that plans of reorganization approved by the I.C.C. or proposed by examiners for 29 companies provide a reduction of $1,577 millions, or 47.6 per cent, in long-term debt outstanding. Adding accruals of unpaid interest, the total reduction of the bondholders' fixed and contingent interest bearing claims is $2,333 millions. The plans for these 29 companies contemplate a reduction in annual fixed charges of approximately $102 millions, or 71.4 per cent.

The increase in working capital through retained earnings during the past two to three years has been phenomenal. At the end of 1940 the net current assets (excess over current liabilities) of Class I roads not in receivership or trusteeship were $477 millions, while by July 31 of this year they had risen to $1,117 millions.

These reductions in debt and increases in working capital will be invaluable after the war in strengthening the basis of railway credit and enabling the roads to continue the capital expenditure under which they have made such progress; at the same time reorganization proceedings for roads in receivership or trusteeship are nearer completion, and recapitalization will restore their credit. In meeting war demands railway plant and equipment have been subject to an acceleration of wear and tear that is without precedent; and shortage of manpower and materials has made normal maintenance impossible. The Interstate Commerce Commission permits the railroads to set aside reserves for this deferred work, and the amount of such reserves this year is estimated to be at least $185 millions. This, however, measures but a little part of what the roads will want to spend after the war. Heavy capital expenditures will be required to replace and modernize equipment. The roads will need rolling stock, rails, ties and ballast, and tools.

Wartime Experience a Permanent Gain

The wartime experience will yield other results benefitting the roads in the post-war period. Advances in operating practice will remain as a permanent gain. As Mr. Ernest E. Norris, president of the Southern Railway, said in an address before the Western Railway Club of Chicago, October 18, the roads "have learned during the war how to do more with less; how to cooperate with shippers and receivers of freight to use the railroad plant more intensively and more efficiently; how to work together for the common good." This progress will carry into the future, to reduce costs and improve service.

Public authorities during the war have been more willing to sanction abandonment of unprofitable branch lines, victims of changed economic and competitive conditions, and the burden of operating such "feeders" at a loss will be lighter.

Perhaps the greatest gain of all, for the long run, will develop from the proof, given during the war, that the service of the railroads is indispensable and that private ownership and management is able and patriotic. The lessons to be drawn from the war achievement should influence both the opinion of the public and the theory and practice of government authorities in dealing with the complex problems which lie ahead.

Post-War Competition

In spite of the carriers' splendid operating record under wartime pressure and in spite of the tangible and intangible improvements that the roads will carry into the postwar period, quoted prices of railroad securities indicate that many investors regard their outlook with a good deal of skepticism. There is apparently a fairly widespread belief that with the war over the carriers will once more find themselves waging a losing fight against such influences as decline in traffic, intense competition from other transportation agencies, and mounting wages and taxes—with the recurring threat of unfavorable legislation in the background.

There is good reason for believing that rail competition will be stiffer after the war in some ways than it was in the '30s; and certainly the railroads must assume this as a

probability. In the past two decades highway competition has been the principal element in reshaping the pattern of transportation. But for three or four years before the war the percentage of total freight traffic obtained by the railroads was holding relatively steady; trucks and buses have been brought under regulation by the Interstate Commerce Commission, and increasing taxes and rising labor costs have in some measure offset the competitive advantage they enjoyed in the form of a publicly constructed and maintained right of way.

Whether or not the roads will lose more business to the highways, however, stiffer competition is in sight from pipelines, water carriers and, in particular, from airplanes. Airplane passenger, mail and express traffic was growing rapidly before the war and is certain to grow rapidly after it. Many foresee a steady flow—although by evolution rather than revolution—of first class passenger and express traffic to the airlines.

Principles of a Transportation System

It would be fruitless to enter into conjecture as to what percentage of traffic airplanes may obtain, and whether "sky trains" will fill the air, not only because of the difficulties of prediction but because highly imaginative projections and extreme opinions pro and con obscure understanding of the principles that should govern the evolution of the transportation system on sound economic lines. The governing principle, from the standpoint of benefit to the country, is that transportation should be by the agency which can meet the country's wants and needs most effectively, efficiently and economically. It is not realistic to suggest that this should be determined by "free" competition, since regulation of transportation is an established and accepted principle; but in the public interest it should be determined by "equal" competition, meaning that government should give advantage to none.

A plea for a single national policy was cogently expressed in a radio discussion on "Tomorrow's Transportation", on Oct. 2, by Mr. F. E. Williamson, president of the New York Central Railroad. Mr. Williamson said:

> After the war the country will have more and better transportation by railroad, by water, by highway and by air than it has ever before enjoyed. There is not yet agreement about the field each form of transport should occupy; but there is an answer to the problem, even if we haven't yet found it. The answer centers in public policy. Our laws today, state and federal—as to regulation, taxation, use of public facilities—lay down one public policy for rail transportation, another for water; still another for highway; and a fourth and different policy for air. Each of these policies has been written with altogether too little regard for the other three and with too little regard for the paramount public interest. We need a unified, national transportation policy, established by Congress and competently administered, that will give us sound cost-reducing competition, not expensive confusion and wasteful lack of coordination. Our transportation laws should, and I am confident will be, welded together into a single consistent and enlightened national policy, springing from informed public opinion, expressed in the American way through our constitutional government.

Although it cannot be said that the country has yet developed a thoroughgoing, unified transportation policy, it is nearer to that goal than it was when the Transportation Act of 1920 was the law of the land. A new attitude is reflected in the Transportation Act of 1940. This legislation—which stems largely from the recommendations of the joint committee of rail executives and labor leaders appointed by President Roosevelt in 1938—contains a declaration of national policy under which Congress pledges itself to treat all modes of transportation fairly and impartially, with railroads, motor carriers, water carriers, pipelines, sleeping car companies and express companies regulated by the same agency in the public interest. This is the first time that Congress has approached the transportation problem in such a comprehensive manner.

The Act provided for the establishment of a Board of Investigation and Research for the purpose of investigating three matters of paramount importance to the railroads. These are: (1) the relative economy and fitness of carriers by railroad, motor and water transportation service, with a view to determining the service for which each is best fitted; (2) the extent to which the various classes of carriers have been subsidized by the Government, and (3) the extent to which taxes are imposed on such carriers by governmental agencies. The Board has released a report on the controversial interterritorial freight rate question; it states that the tax data have been compiled and the analysis of the figures is "nearing completion," and that the report on public aids is "in course of preparation."

Unquestionably there is need for authoritative and completely impartial study of these subjects, divorced from any atmosphere of political influence or dispute, to serve as a basis for establishment of a national policy such as Mr. Williamson urges.

Railroad Plans

Meanwhile railroad management is not lacking in realistic analysis of its competitive problems, or in planning. Railroad men believe, and their opinion meets virtually no dissent, that they can move bulk freight in volume at the lowest cost of any transportation agency. But they do not wish, nor intend, nor would public policy permit them, to accept what Mr. Norris, in the speech referred to, called "the humiliating role of a carrier of that traffic which other forms of transport don't want."

The railroads plan to improve the speed, dependability and economy of their service as

continuously in the future as in the past. They realize that they must focus attention on further increasing speed and cheapness. They foresee a steady increase in passenger trains featuring comfortable, streamlined day coaches, capable of scheduled average speeds of 70 to 75 miles an hour, and scheduled freight trains moving at the speed of many of the country's present passenger trains. To accomplish these ends, declared R. V. Fletcher, vice president of the Association of American Railroads, in an address at Boston on October 18:

> The railroads must ceaselessly prosecute their efforts to improve the service and reduce costs. Much of the equipment now in use must be rebuilt and modernized. The use of light-weight metals and alloys for the construction of cars will increase; tracks, bridges and terminals must be improved or rebuilt; operating methods must be studied with a view to economy; mechanical appliances must be reexamined in the light of technological developments.

Some railroads, like the New York Central, have laid down "five-year plans" or their equivalent in preparing for the future, while all are cooperating in the researches of the Association of American Railroads.

Rail Service Indispensable

In any national transportation system, a fundamental truth—never more appreciated than now—is that adequate rail service, on which more than 60 per cent of the country's freight and commercial passenger traffic normally depend, is indispensable. Since it is indispensable, the country can afford to pay what it costs—as long as management is able and keeps costs down—including a return on capital invested which will maintain railway credit and make possible the continuous modernization and improvement which better and cheaper service to the public requires.

Railroad rates are determined by the cost of service, by the value of the service to the public, by the value of the commodity, and increasingly during the past twenty years by competition. The public interest requires that the railways shall maintain certain services which competitive rates have made unprofitable. In normal times considerable passenger traffic, particularly, has fallen in this category, likewise some part of l.c.l. freight. The railroads have a heavy investment in facilities for these services, and railroad management for many reasons is not only willing but anxious to maintain them, placing its reliance on ability to get costs down, improve service and effect co-ordination. In this task, railroad labor has both a responsibility and a direct interest. At the same time, public policy should see that the competition which makes the services in question unprofitable is sound and economic competition.

Another need which only an appropriate public policy can meet is that in good times the roads should have rates which will permit them to put aside funds against hard times. The obverse of a policy of cutting rates when the roads are doing well is to raise them when earnings fall away; and even if this were desirable it would be impracticable, under competitive conditions.

The Future

One other point of major importance remains, to conclude this necessarily brief survey. No one can foretell what the post-war volume of traffic offered to the transportation systems of the country will be; but it can be said with confidence that most students of the prospect look for a volume of industrial production, trade activity and national income substantially above pre-war levels, for a few years at least. If this is the case the railroad volume may diminish relatively, but gain actually and perhaps substantially, in comparison with 1939. With traffic expansion the progress of the past twenty years would yield tangible results in financial improvement, as it has during the war. Nothing could be more effective in reducing the magnitude of the railroads' problems. Moreover, traffic lost to new agencies is apt to be, in general, the least profitable traffic.

It seems correct to say that there are two objectives before the railway industry. One is to supply the public with better service at lower cost, as during the past twenty years. The second is to accomplish this without the losses which conditions during the '30s forced upon their bondholders and stockholders. These losses have fallen heavily upon insurance policy owners, savings bank depositors, educational and charitable funds; and they have had widespread effects through the economic system.

To avoid a repetition is the fundamental problem. The two requisites are a sound public policy and vigorous private initiative. There is more reason than in the past to expect the former, and the war record is evidence that the latter is not lacking. Miracles in the way of a sudden blossoming of the newest equipment and facilities all over the country are not to be expected, but there are many signs that progress will not be merely continued but accelerated.

Today the railroads are entitled to, and are receiving, the appreciation and good will of the country for their war service. It is something to ponder what the situation would have been, in our greatest national emergency, if private capital had not been invested (and lost) in the railway system, and if private initiative had not been devoted to its improvement and progress.

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